MICHIGAN
LAW REVIEW

VOL. IV JUNE, 1906 NO. 8

THE VALIDITY OF CONTRACTS BETWEEN CORPORATIONS HAVING COMMON DIRECTORS

AMONG many who heed the results of the examinations into the methods of trust, corporation and extensive financial activities, there is a conservative belief that improvement is to be secured not by sweeping alterations in legislation, or revolutionary conversions in public opinion, but by persistent and skilful reformation of the detail of law itself. The recommendations of the Armstrong insurance committee of New York bear adequate witness to this fact.

But it is interesting to note that most of the recommendations have been addressed to executive and legislative authority, not to the judiciary. This is but natural, considering the purposes of these recommendations and the sources from which they emanate. And yet the plan which neglects the judiciary is not as highly practical as it might be. With the judges remains in great measure the determination of the adequacy of the law affecting corporate and financial organizations. The bench plays an inestimable part in shaping this law. No doubt it will be appropriately memorialized in due time, but by the judges themselves, or the legal profession, who are the proper custodians of the law as a science. Until that time comes, however, will it not be of value to give some study to certain phases of the law for which the courts are peculiarly responsible?

The contract between corporations having common directors is common in business at the present time. It is oftentimes useful and valuable to all concerned. But it offers peculiar opportunities for fraud and oppression. It is an open gateway through which unscrupulous interests can pass to dishonest advantage, and through which the weaker can often be turned to their ruin. There can be

no doubt that it demands consideration—consideration at the hands of the bench as much as anywhere. It is the judiciary that has made the law concerning such contracts, and they can best alter it if need be. An examination of the decisions will suggest the problems involved.

It may be premised that contracts between corporations having common officers present practically the same questions as these between corporations having common directors. Furthermore, it makes little difference whether the common directors constitute a majority on either or both boards[1]. Where, however, the decisions have turned upon, or have been materially affected by these differences, special note will be made of them.

I.

CONTRACTS VALID—*Prima Facie.*—A number of courts have taken the ground that contracts between corporations cannot be attacked on the sole ground of common directorship. If it is desired to have such contracts set aside, or to enjoin their performance, an affirmative showing of illegality, fraud or *ultra vires* action must be made. *Prima facie* such contracts are valid and the burden rests upon the one alleging their unfairness. Certain of these cases do not even go to the length of holding these contracts subject to strict scrutiny. But they are few in number, and in most instances it seems that if the court had been called upon to express itself upon that point it would have declared for such scrutiny. The Maryland courts have treated these contracts liberally. In the case of *Cannon* v. *Brush Electric Co.*,[2] it was held that the fact that one of the two corporations between which the contract was made held a controlling interest in the other and elected directors of the other—the directors of one company being directors of the other—did not indicate fraud. The burden of proving fraud or mismanagement rested upon the plaintiff. And in the case of *Shaw* v. *Davis*,[3] the court said: "The fact that the same persons hold the majority of the stock in both companies does not of itself enlarge the court's jurisdiction; the act complained of furnishes the test of jurisdiction,

[1] See opinion by HARLAN, J., in Jesup *v.* Illinois Cent. R. Co. (1890), 43 Fed 483; San Diego, O. T. & P. B. R. Co. *v.* Pacific Beach Co., Calif. (1896), 44 P. 333; Metropolitan etc. R. *v.* Manhattan etc. Co., N. Y. 1884, 14 Abb. N. C. 103; 11 Daly 373, p. 287, et seq. But see Pierce *v.* Old Dominion Mining & Smelting Co., New Jersey (1904), 58 Atl. 519; Bell *v.* Western Union Tel. Co. (1883), 16 Fed. 14; German National Bank *v.* Hastings First National Bank, 1898, 55 Neb. 86.

[2] (1903) 96 Md. 446; 54 Atl. 121.

[3] (1894) 78 Md. 308; 28 Atl. 619; 23 L. R. A. 294.

and it must be *ultra vires,* fraudulent or illegal; nothing short of this will suffice. This is true even where directors and not stockholders do the act complained of." The language in these cases is quite strong. But both cases place great reliance on the decision in *Booth* v. *Robinson,*[4] in which, while it was held that common directorship "does not afford ground of presumption against the legality and fairness of the dealings and transactions between the two companies," it was asserted that this fact "should subject their conduct to rigid scrutiny by the courts."

In the case of *Manufacturers' Savings Bank* v. *O'Reilly,*[5] the court declared that a sale of corporate property to pay debts, the sale being made by persons who were directors in both the buying and selling corporation, did not give stockholders of the latter ground for complaint. However, more than the value of the property was realized on the sale; had it been otherwise stockholders could have recovered the losses sustained. Some of these cases take a very broad position in maintaining that there is no antagonism, no adverse interest in the common directorship. In an interesting insurance case, *Alexander, Receiver,* v. *Williams,*[6] it was said: "It is a well settled principle that one person cannot act in a trade in two positions which impose different obligations which would raise a conflict between interest and duty. Directors of corporations and all persons acting in a fiduciary capacity are subject to this rule. * * * Nevertheless we have found no case where it has been held that a transaction between two corporations is void merely because all the directors of one corporation were also directors of the other."

And in the case of *Booth* v. *Robinson,*[7] plausibly assuming that the double allegiance was feasible, it was declared that the common directors "were interested in both companies, and by their relations

[4](1881) 55 Md. 419. And see Davis *v.* U. S. Electric Power & Light Co. (1893), 77 Md. 35.

[5](1888) 97 Mo. 38.

[6](1883) 14 Mo. App. 13. In San Diego, O. T. & P. B. R. Co. *v.* Pacific Beach Co., Calif. (1896), 44 P. 333, the court said, "When two corporations, through their boards of directors, make a contract with each other, the directors who are common to both are not within the rigid rule of the cases which hold that one who acts in a fiduciary capacity cannot deal with himself in his individual capacity, and that any contract thus made will be declared void without any examination into its fairness, or the benefits from it to the cestui que trust. Two corporations have the right within the scope of their chartered powers to deal with each other; and this right is certainly not destroyed or paralyzed by the fact that some, or a majority of the directors, are common to both. Of course if such directors should wrongfully and wilfully use their powers to the prejudice of one of the corporations, their action, if not acquiesced in, and if contested at the proper time, could be avoided, as in any other case of actual fraud."

[7] *Supra.*

to and official position in them, they owed duties, and were bound to be faithful alike, to both."

A contract between a partnership and a corporation, a member of the firm being promoter of and superintendent in the corporation has been sustained.[8] Contracts have been declared valid though the corporations have common officers.[9] Thus in *St. Joe & M. F. Consol. Min. Co.* v. *First National Bank*[10] it was roundly asserted that "Corporations so situated have an undoubted legal right to deal with each other; and, although their contracts and agreements may be attacked and set aside in a court of equity, it is first necessary to show that some unconscionable advantage was taken by one of the other, or that a fraud was perpetrated upon one by virtue of the same party being president of both."

In certain cases qualifications are introduced and thus they fall somewhat short of the declaration that all contracts between corporations having common directorship are valid if not attacked on other grounds. But in the specific cases to which reference is here made the reader is impressed with the thought that had the court been called upon to take so bold a stand it might have done so. Thus in *Larwill* v. *Burke*[11] it was held that such a contract would not be set aside after years of acquiescence. In *Grant* v. *United, etc., Ry.*,[12] a sale of property by one corporation to another, all of the directors except one being common, was held legal when such sale was subsequently ratified by a meeting of the stockholders. And in *United States Rolling Stock Co.* v. *Atlanta & G. W. R. Co.*[13] it was held that a contract between two corporations, a minority of the board of directors of one being directors of the other, was not for this reason voidable at the election of one of the parties thereto. In the latter case, however, this court gave a very false impression of the condition of the law, saying: "We have not upon the most diligent research, been able to find a case holding a contract between two corporations by their respective boards of directors invalid, or void-

[8] Pratt *v.* Oshkosh Match Co. (1895), 89 Wis. 406.

[9] City of Griffin *v.* Inman (1876), 57 Ga. 370; Leathers *v.* Janney (1889), 41 La. Ann. 1120; 6 South. 884.

[10] (1897) 50 Pac. 1055 (Colo. App.).

[11] 9 O. Cir. Ct. 449. In Schumacher *v.* Edward P. Allis (1896), 70 Ills. App. 556, persons acting as the officers of two corporations operated the two as if they were but one company, and as officers for one company contracted for machinery to be placed and used in the plant of the other. At a later date as officers of the latter company they gave its notes for the purchase price of the machinery. It was held that the authority of the company making the purchase to act for the other company could not be questioned for the purpose of avoiding a clause of the contract authorizing the removal of the machinery in case of non-payment.

[12] (1888) L. R. 40, Ch. D. 135.

[13] (1878) 34 O. St. 450.

able at the election of one of the parties thereto, from the mere circumstance that a minority of its board of directors are also directors of the other company." As will be pointed out later on many such cases are to be found, and many were to be found at the time when this opinion was written.[14]

Contracts Subject to Strict Scrutiny.—In various instances the courts have refused to pronounce these contracts *per se* invalid in cases of common directorship but have expressed the opinion that they should be regarded by equity "with a large measure of watchful care," that they are "open to suspicion," or that they should be "subject to strict scrutiny."

In the case of *Davis* v. *United States Electric Power & Light Co.*[15] it was held that the fact that members of the board of directors of one corporation were interested in a second corporation with which the first had made a contract would subject the conduct of such persons to rigid scrutiny. The Court further said: "The gravamen of the complaint made by the bill is, that the Brush Company, having obtained control of the management of the United States Company, is using its power to make that company subservient to its own interests, to use it as a feeder and finally utterly to destroy it, whenever it shall be to their profit so to do. This, as was said in *Booth* v. *Robinson* (*supra*) would be a fraud of the most flagrant character. It would subject the corporations at whose instance the scheme was devised and executed, not only to a civil liability for the injury done, but also to the penalties of misuser or abuser of its franchises." No other case seems to contain so forcible a statement of the effects of such contract upon the corporate franchises.

The doctrine in these cases is the same as that often applied to contracts between a corporation and its directors.[16]

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[14] For further authority on the validity of contracts between corporations having common directors, see Canal Bridge *v.* Gordon (Mass. 1823), 1 Pick. 297; 11 Am. Dec. 170, Purdy's Beach on Corporations, ed. (1905), p. 1113, § 744, and 10 Cyc. 818, where the statement is particularly strong; also Reid, Corporate Finance I, pp. 274-76. In Re Mercantile Library Hall Co. *v.* Pittsburgh Library Ass'n, 25 Pittsb. L. J. 345. The law as to notice and identity of interest sometimes becomes of particular importance. See Mich. Slate Co. *v.* Iron Range & H. B. R. Co. (1894), 101 Mich. 14, 59 N. W. 646; Golden Reward Min. Co. *v.* Buxton Min. Co. (1897), 79 Fed. 868; Central National Bank *v.* Pipkin (1896), 66 Mo. App. 592; Block Queensware Co. *v.* Metzger (1901), 70 Ark. 232, 65 S. W. 929.

[15] (1893) 77 Md. 35, 25 Atl. 982; Davidson *v.* Mexican Nat. R. Co. (1893), 58 Fed. 653; Hill *v.* Gould (1895), 129 Mo. 106, 30 S. W. 181; Booth *v.* Robinson (1881), 55 Md. 419. In Purdy's Beach on Corporations (1905), § 744, p. 1113, it is said that contracts between corporations having common directors will be subject to strict scrutiny only when prejudicial to one corporation, citing Booth *v.* Robinson, 55 Md. 419; Mayor etc., of Griffin *v.* Inman, 57 Ga. 370; U. S. Rolling Stock Co. *v.* Atlanta etc., R. Co., 34 Ohio St. 450, etc. The qualification is not fully borne out by the case cited. See Jesup *v.* Illinois Central R. Co. et al. (1890), 43 Fed. 483.

[16] McGourkey *v.* Railway (1892), 146 U. S. 536; Hubbard *v.* New York, N. E. & W. Investment Co. (1882), 14 Fed. Rep. 675, 676; Reid, Corporate Finance I, pp. 250, 266, 267.

Contracts Must be Fair.—The series of cases next in logical order not only subjects these contracts to strict scrutiny, but declares that they will not be sustained if not shown to be fair. If fair they are enforceable.

In *Evansville Public Hall Co.* v. *Bank of Commerce*[17] the court, adopting the language of counsel for appellant, said, "where the same directors act in two companies their contracts are closely scrutinized, and will not be upheld unless manifestly fair." But, accepting the words of the counsel for the appellee, it further declared that "while a contract between two corporations having common directors may be voidable, it is only so when the contract is in fraud of the interests of one of the corporations, and will never be set aside by the courts when the honesty of the transaction is manifest." In *Montgomery Traction Co.* v. *Hanna*[18] the court declared that the contracts between two corporations, the directors and officers of one of which were dominated by the other corporation, "must be regarded as if between a corporation and its directors or other trustees, and must be governed by the same principles. * * * The court will set such contracts aside unless fair and reasonable." It has been held that the contract must be open and free from any suspicion of secret dealing in favor of one principal while acting as the representative of the other.[19] The case of *Goodin* v. *Cincinnati & W. Canal Co.*[20] gives a good illustration of the conditions under which such a contract can be effectually attacked. A railroad company had purchased a majority of the shares of stock of a canal company. For the canal company it elected a board of directors, who were in the interest of the railroad company, and then, with the assent of this board, appropriated the entire canal and property of the canal company as a railroad track, paying a price agreed upon by the directors of the two companies, but which was far below the actual value of the property. It was held that although the stockholders and creditors of the canal company could not reclaim the property or enjoin its use after the road had been completed, yet they were not concluded by such agreement so far as regarded the price of the property, but might compel the railroad company to account for its additional value.[21]

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[17](1896) 144 Ind. 34, 42 N. E. 1097. In German National Bank *v.* Hastings First National Bank, 1898, 55 Neb. 86, such contracts are held to be presumptively invalid.

[18](1904) 140 Ala. 505, 37 So. 371.

[19]Mercantile etc. Co. *v.* Pittsburgh etc. Assoc. (1896), 173 Pa. St. 30.

[20](1868) 18 O. St. 169, 98 Am. Dec. 95.

[21] See also Pierce *v.* Old Dominion Mining & Smelting Co. (N. J., 1904), 58 Atl. 319; Salina Nat. Bank *v.* Prescott (1899), 60 Kan. 490, 57 P. 121.

II.

CONTRACTS VOIDABLE.—The rule upheld by most courts is that contracts between corporations having common directors are voidable.[22] Many cases hold that such contracts may be avoided "without regard to the question of advantage or detriment."[23] It is declared that "corporations are armed with the right to repudiate such a transaction no matter how fair and open it may be shown to be."[24] Not all cases declaring such contracts voidable can be held to state so broad a rule, however. A close examination of the facts and opinion in certain instances will reveal fraud or a breach of trust, and though the court indulges a broad denunciation the attending circumstances inevitably limit the rule, in the absence of a specific utterance to prevent that effect.[25]

Here as elsewhere it makes little difference whether the common directors constitute a minority of one and majority of the other or whether the two boards are identical.[26] Thus it is said in *Smith* v. *F. & C. H. Ry. Co.*,[27] "the mere fact that these corporations dealt with each other, all having the same board of directors, does not stamp the transaction void ipso facto. It is no more void than though one director should sell his corporation a plant for the conduct of a factory. Under any circumstances it would be voidable only."[28]

Fiduciary Relationship as Ground for Avoidance.—The relation in which the director stands to the corporation has been very generally described as fiduciary. Not that the director is a trustee and the stockholders *cestuis que trustent.* A few cases have used this description,[29] but the majority seem inclined to describe the relation

[22] Elliott, Private Corporations, 3rd ed., pp. 553, 554; Twin Lick Oil Co. *v.* Marbury, 1875, 91 U. S. 587; Atala Iron Ore Co. *v.* Virginia Iron, Coal & Coke Works (Tenn., 1903), 77 S. W. 774.

[23] O'Connor etc. Co. *v.* Coosa etc. Co., 1891, 95 Ala. 614. But see German Nat. Bank *v.* Hastings First Nat. Bank (1898), 55 Neb. 86.

[24] *Ibid.* And see McLeod *v.* Lincoln Medical College of Cotner University, Neb., 1903, 96 N. W. 265; Fitzgerald *v.* Fitzgerald, 1895, 44 Neb. 463, and cases cited.

[25] But the mere fact that one corporation gains control over another does not of itself constitute fraud. Kitchin *v.* St. Louis, K. C. & N. Ry. Co. (1878), 69 Mo. 224. See Memphis & Charleston R. R. Co. *v.* Woods (1889), 88 Ala. 630.

[26] Roberts *v.* Washington National Bank (1895), 11 Wash. 550, 50 P. 225.

[27] Calif., 1897, 51 P. 710.

[28] Citing Oil Co. *v.* Marbury, 91 U. S. 587; Hammond *v.* Hopkins, 142 U. S. 224; Barr *v.* R. R., 125 N. Y. 263.

[29] Graves *v.* Mono Lake Hydraulic Co., Col. (1890), 81 Calif. 303, 22 P. 665; Reid, Corporate Finance I, pp. 241, 242, and cases cited; Hubbard *v.* N. Y., & W. Investment Co., 14 Fed. 675.

as one of quasi-trusteeship.[30] The position of the director is without doubt *sui generis,* but certain it is that as a rule his office is affected with a trust.

Thus in a New Jersey case[31] it was said, "the board of directors occupied a fiduciary position in which they are practically to be regarded as trustees for the stockholders as cestuis que trust."[32]

Upon the doctrine of fiduciary relationship, then, have these contracts not infrequently been declared voidable. Thus in the case of *G. C. and S. R. R. Co.* v. *Kelly et al.*[33] it was held that, in an important sense, the directors of a railroad company are to be regarded as trustees for the stockholders. To transfer the trust, to assume obligations inconsistent with that relation, to place themselves in opposition to the interests of the stockholders or in such a position that their individual interests would prevent them from acting for the best interests of those they represent,—these things would amount to a breach of duty. And so it was held that when such a director makes a contract for the building and equipping of the road and reserves a private interest or subsequently becomes interested in its execution with a view to participate in the profits of the contract, the *cestui que trust* or stockholders, may, at their election, ratify the act, and insist upon the advantages of it, or disaffirm it *in toto.* And it was declared that the rule which prohibits a trustee or agent from assuming a position tending to produce a conflict between his individual interest and a faithful discharge of his fidu-

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[30] Memphis & Charleston R. R. Co. *v.* Woods (1889), 88 Ala. 630.

In Spring's Appeal (1872), 71 Pa. St. 11, it was said: "They are undoubtedly said in many authorities to be trustees, but that as I apprehend is only in a general sense. * * * * It is certain they are not technical trustees. They can only be regarded as mandataries—persons who have gratuitously undertaken to perform certain duties and who are therefore bound to apply ordinary skill and diligence, but no more. * * * * Gentlemen elected by the stockholders from their own body ought not to be judged by the same strict standard as the agent or trustee of a private estate."

[31] Kelsey *v.* New England St. Ry. Co. (1901), 62 N. J. Eq. 742, 48 Atl. 1001.

[32] And see cases cited. In Twin Lick Oil Co. *v.* Marbury (1875), 91 U. S. 587, the court said: "That a director of a joint stock corporation occupies one of those fiduciary relations where his dealings with the subject-matter of his trust or agency, and with the beneficiary or party whose interest is confided to his care, is viewed with jealousy by the courts, and may be set aside on slight grounds is a doctrine founded on the soundest morality and which has received the clearest recognition in this court and in others." See Wickersham *v.* Crittenden (1892), 93 Cal. 17; Torrey & Gilbert *v.* The Bank of Orleans, New York (1842), 9 Paige 648; N. Y. Cent. Ins. Co. *v.* Nat'l Protective Ins. Co. (1856), 14 N. Y. 85; Butts *v.* Wood (1867), 37 N. Y. 317; Duncomb et al. *v.* N. Y., H. & N. R. R. Co. (1881), 84 N. Y. 190; Marie *v.* Garrison, N. Y. (1883), 13 Abb. N. C. 214; Metropolitan Electric Ry. Co. *v.* Manhattan Electric Ry. Co., N. Y. (1884), 14 Abb. N. C. 103, distinguishing relation of director and stockholder to the corporation; Currier *v.* New York etc., R. Co. (1885), 35 Hun. 355; Barr *v.* New York, L. E. & W. R. R. (1891), 125 N. Y. 274; Boaz *v.* Sterlingworth (1902), 73 N. Y. S. 1039.

[33] (1875) 77 Ills. 426.

ciary duties, is so strict that no question will be allowed to be raised as to the fairness of the transaction, and no actual injury to the *cestui que trust* need be shown.[34]

In *Hoffman Steam Coal Co.* v. *Cumberland Coal and Iron Co.*[35] the doctrine that trustees cannot purchase at their own sales was applied to purchases by persons acting in any fiduciary capacity which imposes upon them the obligation of obtaining the best terms for the vendor, or which has enabled them to acquire a knowledge of the property. A director of a corporation, it was said, stands in such a position.

Adverse Interest as Ground for Avoidance.—In the case of *Fitzgerald* v. *Fitzgerald, etc., Co.*[36] it was averred that "another intrinsic vice of the transaction is that a majority of the directors of the construction company were, by reason of adverse interest, disqualified to act therein." And later, "Each party to the agreement was interested in securing the most advantageous terms consistent with fair dealing and the rights of the others, hence Messrs. Gould and Sage [directors in both corporations] could not at the same time protect the rights of both corporations." In a number of cases this element of adverse interest has been much emphasized in declaring the contract voidable.[37]

One of the most interesting—as it is one of the most frequently cited—cases upon this entire subject is *Wardell* v. *R. R. Co.*[38] In this case the court said: "It is among the rudiments of the law that the same person cannot act for himself and at the same time, with respect to the same matter, as the agent of another whose interests are conflicting. * * * Hence all arrangements by directors of a railroad company, to secure an undue advantage to themselves, at its expense, by the formation of a new company as an auxiliary to the original one, with an understanding that they, or some of them, shall take stock in it, and then that valuable contracts shall be given to it, in the profits of which they, as stockholders of the new company, are to share, are so many unlawful

[34] And see Fitzgerald *v.* Fitzgerald (1895), 44 Neb. 463, where such contracts were condemned on grounds of adverse interest, public policy, and—by adoption of part of the opinion in another case—fiduciary relations. Sweeney *v.* Sugar Refining Co. (1887), 30 W. Va. 443.

[35] (1860) 16 Md. 456.

[36] (1895) 44 Neb. 463.

[37] See O'Connor etc. Co. *v.* Coosa etc. Co. (1891), 95 Ala. 614; Bear River Valley Orchard Co. *v.* Hanley (1897), 15 Utah 506. In Ashurst's Appeal (1869), 60 Pa. St. 314, it is said: "But I repeat the question, why may not directors sell to themselves in any case? It is because of the danger that the interests of the stockholders may suffer, if such sales be permitted, for want of antagonism between the parties to the contract."

[38] (1880) 163 U. S. 651.

devices to enrich themselves to the detriment of the stockholders and directors of the original company, and will be condemned whenever properly brought before the courts for consideration." The doctrine has been applied to identity of membership of the corporation itself, and so where the individuals composing one corporation formed a majority of another and separate corporation it was held that they could not as agents of the first apply to themselves as agents of the second, for a lease of the property of the latter, and then, as agents of the same, grant it as on such terms as should please themselves as agents of the former, in opposition to the wishes and protests of their co-corporators of the latter corporation, and to their exclusion.[39]

Agency as Ground for Avoidance.—Closely connected with the doctrines of trusteeship and of adverse interest, under which these contracts are pronounced voidable, is that of agency. The rule that the agent may not deal with himself as principal or agent of another principal, is well-nigh inflexible. Therefore, if the director of a corporation in making a contract with another of which he is also director may be said to act merely as agent, such contracts would be condemned. And some cases proceed, in greater or less degree, upon this theory.[40] As said in *Wardell* v. *R. R. Co.*[41] "it is among the rudiments of the law that the same person cannot act for himself and at the same time, with respect to the same matter, as the agent of another whose interests are conflicting."[42]

But it was held in the *Aldine M'f'g Co.* v. *Phillips*[43] that the fact that a contract between two corporations was made by a person who was agent for and stockholder in both does not render it void. The court said: "This interest, however, does not render the contract and dealings between the two absolutely void. When the transactions are open, honest and fair, and known to the officials of both companies, they will be sustained. The courts view with jealousy the transactions of the man who stands in such a capacity, and will hold him to a strict account of his dealings. He must show that he has acted with clean hands, and when this is shown the transaction will be sustained."

Public Policy as Ground for Avoidance.—Resort has sometimes

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[39] Knabe *v.* Ternot (1861), 16 La. Ann. 13.

[40] Bell *v.* Western Union Tel. Co. (1883), 16 Fed. 14; Knabe v. Ternot (1861), 16. La. Ann. 13; G. C. & S. R. Co. *v.* Kelly et al. (1875), 77 Ills. 426; O'Connor etc., Co. *v.* Coosa etc., Co. (1891), 95 Ala. 614; and see People *ex rel v.* Township Board (1863), 11 Mich. 222.

[41] (1880) 163 W. S. 651.

[42] And see Cumberland Coal Co. *v.* Sherman et al., New York (1859), 30 Barb. 553.

[43] (1902) 129 Mich. 240, 88 N. W. 632.

been had to the doctrine that such contracts are against public policy. This, however, appears to be infrequent. Where used at all it is rather to bolster up other arguments. It is apparently not deemed a sufficient argument in and of itself. Thus it has been said that "the law has placed the seal of its disapproval upon the transaction and pronounced it fraudulent, not on account of any imputed evil purpose * * * but from motives of public policy."[44]

Fraud as Ground for Avoidance.—The mere fact of common directorship is sufficient in the minds of some courts to determine the fraudulent character and hence the voidability of these contracts. Such was the judicial attitude in the case of *Fitzgerald* v. *Fitzgerald*[45] heretofore considered. The integrity, the motives, the fair dealing of the directors are ignored. They are of no effect if there is common directorship. But while courts may declare such contracts voidable on other grounds than fraud, actual or constructive, it will be found that they seldom consider these contracts as such to be fraudulent unless some element of unfairness, of preferential dealing is actually present. Thus in the case of *Sweeney* v. *Sugar Refining Co.*[46] the board of directors ordered the conveyance of all property, real and personal, of the corporation to secure a large debt due from it to another corporation. This was done in a meeting at which one or more of the directors who participated and voted for the conveyance were also directors of the corporation for whose benefit the conveyance was made. It was held that the conveyances were *prima facie* fraudulent and void as to the plaintiff and other creditors in these causes. But the corporation, whose creditors made the conveyance, was insolvent. And so in the case of *Wardell* v. *R. R. Co.*[47] the directors had made a previous agreement with the contractors for a joint interest in the contract, and in order that they might not appear as co-contractors had agreed that a corporation should be formed in which they should become stockholders and to which the contract should be assigned. This was so well understood that when the contractors commenced their work they kept their accounts in the name of the proposed company.[48]

[44] Fitzgerald *v.* Fitzgerald etc., Co. (1895), 44 Neb. 463; and see Memphis & Charleston R. R. Co. *v.* Woods (1889), 88 Ala. 630; In re Ft. Wayne Electric Corp. (1889), 95 Fed. 264.

[45] (1895) 44 Neb. 463.

[46] (1887) 30 W. Va. 443.

[47] (1880) 163 U. S. 651.

[48] Brinckerhoff *v.* Roosevelt (1904), 131 Fed. Rep. 955, involving a contract between corporations with common officers presents a suggestive state of facts. The defendant was president and trustee of a building association. In connection with other trustees who were authorized to transact the business of the association, he sold the only property of the association, certain real estate, to a trust company of which he was also president

Avoidance and Ratification.—The contract may be avoided or ratified. Formal ratification is not necessary. Mere acquiescence is sufficient. In *O'Connor, etc., Co.* v. *Coosa, etc., Co.*[49] it is held that either corporation may avoid, but that creditors may not assail the contract except for fraud. And of ratification it is said, "a principal may consent to be bound by a contract made for him by an agent who, at the same time, represented an interest adverse to that of the principal. A *cestui que trust* may elect to confirm a transaction which he could have repudiated on the ground that the trustee had an interest in the matter not consistent with his trust relation. In like manner dealings between corporations, represented by the same directors, may be accepted as binding by each corporation and the stockholders thereof. They become binding if acquiesced in by the corporations and their stockholders."[50]

The ratification to be binding must be with full knowledge of the facts. Thus in *G. C. & S. R. R. Co.* v. *Kelly et al.*[51] it was declared that no ratification will estop the corporation unless it has been made aware of all the material facts and circumstances of the transaction that would in any way influence it or affect the transaction.

Some authorities take a more extreme position, holding that there must be knowledge of the law as well. In *Hoffman Steam Coal Co.* v. *Cumberland Coal & Iron Co.*[52] it was declared that to render the

and a large stockholder. In exchange certain securities of doubtful validity and value were given. However, a bond and mortgage were taken from the trust company as a guaranty of the collection of the securities to the amount of the agreed price of the property, but by agreement the mortgage was not recorded. The trust company desiring to sell the property, defendant procured the passage of a resolution by the trustees of the building association authorizing the cancellation of the mortgage, and it was so cancelled without the knowledge or consent of the stockholders. The trust company was insolvent, or became so, and nothing was realized by the building association from the securities. The court held that the cancellation of the mortgage operated as a fraud upon the association, by depriving it of its only valid security, and rendered defendant individually liable for the price of the property, which liability could be enforced at the suit of the stockholders, the association having refused to bring the suit.

[49] (1891) 95 Ala. 614.

[50] Citing Kelly *v.* Newberryport Horse Railroad, 141 Mass. 496; Ashurst's Appeal, 60 Pa. St. 290, 314; Buell *v.* Buckingham, 16 Iowa 284; Manufacturers' Savings Bank *v.* Big Muddy Iron Co., 97 Mo. 38; Alexander *v.* Williams, 14 Mo. App. 13; Twin Lick Oil Co. *v.* Marbury, 91 U. S. 587; Booth *v.* Robinson, 55 Md. 419; U. S. Rolling Stock Co. *v.* Atlantic and Great Western R. Co., 32 Am. Rep. 390; Taylor on Private Corporations (2d ed.), § 630; 1 Beach on Private Corporations, § 247. But in Thomas *v.* Brownville, Fort K. & Pac. Ry. Co. (1880), 2 Fed. Rep. 877, it was held that long acquiescence would not estop the stockholders, and that the contract could not be ratified save by a board of disinterested directors. In this case, however, the contract was declared to be void rather than voidable. And so in Coodell *v.* Verdugo Canon Water Co., 1903, 138 Calif. 308, in which the contract was declared to be illegal, it was held that a corporation is not estopped from challenging the validity of a contract, made on its behalf by its directors interested therein adversely to the corporation, by laches on the part of such directors.

[51] (1875) 77 Ills. 426; and see cases cited.

[52] 16 Md. 456. But see the later Maryland cases, *supra*.

ratification conclusive and effective the principal must at the time of the ratification, not only be fully aware of every material fact, and his act of ratification be an independent, substantive act founded on complete information, but he must as well be "apprized of the law as to how these facts would be dealt with if brought before a court of equity."

Incidents of the Doctrine of Avoidance.—Taking the decisions as a whole, the question as to who is the proper party to maintain suit for avoidance of the contract cannot be said to have provoked much contention, or even much discussion. In several jurisdictions, however, this point has become of material importance. Such it will be seen is the case in New York.

Avoidance by the stockholders is not uncommon, and frequently it is permitted at the instance of a minority or, it may be, a single stockholder. In some cases the language is more general, and indeed in certain instances indefinite. Thus it is said that the "corporation" may avoid.[53] In *Sweeny* v. *Sugar Refining Co.*[54] the contract is voidable "at the election of the corporation itself or its stockholders." Such a contract is declared voidable (where a trustee whose presence is necessary to make a majority of the whole number is interested in another corporation, to whom the board voted to lease the corporate property) "on complaint of a stockholder."[55] And in *Knabe* v. *Ternot*[56] when the individuals comprising one corporation formed another and separate corporation with which they made a contract it was held that the individual corporator might sue in their individual names. In *Bell* v. *Western Union Tel. Co.*[57] it was said, however, that an individual stockholder can maintain an action to set aside such a contract only when it is made to appear to the court that he has exhausted all the means to obtain, within the corporation itself, the redress of his grievances, or action in conformity with his wishes, and that he has made proper effort to induce action on the part of the other stockholders. Other courts while apparently not placing power so great in the hands of the individual stockholder, will permit a minority to avoid. Thus in *Fitzgerald* v. *Fitzgerald*[58] it is said that a contract may be avoided "at

[53] O'Connor etc., Co. *v.* Coosa etc., Co. (1891), 95 Ala. 614.

[54] (1887) 30 W. Va. 443. Similar language is employed in Jesup *v.* Illinois Central R. Co. et al. (1890), 42 Fed. Rep. 483. In G. C. & S. R. Co. *v.* Kelly et al. it is said that the *cestui que trust* or stockholders may at their election ratify or disaffirm.

[55] Parsons *v.* Tacoma Smelting and Refining Co. (1901), 25 Wash. 492, 65 P. 765; Pierce *v.* Old Dominion Mining & Smelting Co. (N. J. 1904), 58 Atl. 319, limiting this doctrine.

[56] (1861) 16 La. Ann. 13.

[57] (1883) 16 Fed. 14.

[58] (1895) 44 Neb. 463.

the suit of non-consenting stockholders." In *McLeod* v. *Lincoln Medical College of Cotner University*,[59] it is said (syllabus by the Court), "The minority stockholders can maintain an action in their own names to set aside an illegal transfer of all property and good will of the corporation pursuant to instructions of the majority of the stockholders," and in *Memphis & Charleston R. R. Co.* v. *Woods*[60] "a court of equity will intervene by injunction, at the suit of the minority of the stockholders." There is a conflict as to the rights of creditors to intervene and secure the avoidance of such contract.[61]

Avoidance of the contract must sometimes be accompanied by reimbursement of the contracting party who would otherwise be injured. Thus in *Thomas* v. *Brownville, Ft. K. & P. R. Co.*[62] it was held that notwithstanding the invalidity of the contract, the holders of bonds in a suit for foreclosure of a mortgage were entitled to a decree for the payment of the sums actually expended for construction under the contract, and remaining unpaid, which were payable and paid in bonds declared void.[63]

The doctrines of notice affecting these contracts are sometimes of importance and interest. In *Victor Gold and Silver Mining Co.* v. *National Bank of the Republic*[64] it is held that "when the officer is acting partly for himself and partly for the corporation, a notice to him does not affect the corporation;" but in *Berry* v. *Rood*[65] it is held that where a corporation borrowing and a corporation lending money are represented in making the loan by one who is the president of both corporations his knowledge that the capital stock of the borrowing corporation has been paid up in property at an inflated value is notice to the lending corporation.

III.

CONTRACTS INVALID.—In a number of cases it has been said that contracts between corporations having common directors are never

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[59] Neb. (1904), 98 N. W. 672.

[60] (1899) 88 Ala 630; and see March *v.* Eastern R. Co. (1860), 40 N. H. 548.

[61] See Sweeny *v.* Sugar Refining Co. (1887), 30 W. Va. 443, where such right is upheld. This case contains a good criticism of cases submitted in support of a contrary doctrine. But see O'Connor etc., Co. *v.* Coosa etc., Co. (1891), 95 Ala. 614, where it is said creditors cannot assail such a contract except on ground of fraud.

[62] (1883) 109 U. S. 522.

[63] See also Wardell *v.* Union Pacific R. R. Co., 103 U. S. 651.

[64] (1897) 15 Utah 391, 49 Pac. 826, citing 4 Thomp. Corp., § 4657. And see Trapp *v.* Fidelity Nat. Bank, Ky., 1897, 43 S. W. 470; Stevenson *v.* Bay City (1872), 26 Mich. 44; Gunsten *v.* Scranton Illuminating Heat & Power Co. (1897), 181 Pa. St. 550.

[65] (1902) 168 Mo. 316. And see Glendale Investment Association *v.* Harvey Land Co. (1902), 114 Wis. 408; Gallery *v.* National Exch. Bank (1879), 41 Mich. 169.

void, that they are, at the most, merely voidable.[66] Indeed on occasion some courts have ventured to declare that no authority is to be found which holds such contracts void.[67] These statements are too broad. While few if any cases exist holding such contracts absolutely void on the sole ground of common directorship several are to be found which declare such contracts not binding[68] but capable of ratification, while the decisions are rather numerous in which such contracts, when tainted with the breath of fraud or unfair dealing, are declared invalid. Fraud is the normal accompaniment of those contracts which have received such severe treatment.

In *Thomas* v. *Brownville, Fort K. and Pac. Ry. Co.*,[69] it was held that the contract between a railroad and a construction company is void when any of the directors of the railroad are members of the construction company, unless ratified by a board of disinterested directors. The stockholders of the railroad are not estopped by long acquiescence in such a contract. The court declared that "the least that can be required in such a case is that directors concerned in the contract shall resign and allow their places to be filled by persons who can, without bias, represent the interests of the corporation and particularly of the individual stockholders." This is one of the few cases in which the court seems to have approached a declaration that contracts between corporations having common directors are *ipso facto* void. And yet so broad a conclusion should not perhaps be adopted. The contract was otherwise impeachable, the court saying, "I am unable to construe this contract as anything else than a promise to pay each member of the board individually a consideration for his action as a director in voting for and executing the construction contract. * * * I am clearly of the opinion that the contract is so clearly illegal, against public policy, and vicious that a court of equity cannot enforce it or grant any relief upon it." Again in *Coodell* v. *Verdugo Canon Water Co.*,[70] where the majority

[66] Thus in Jesup *v.* Illinois Cent. R. Co. (1890), 43 Fed. Rep. 483, the assumption that such a contract is void is called a "fundamental error."

[67] Alexander, Receiver *v.* Williams (1883), 14 Mo. App. 13, *supra.*

[68] Bear River Valley Orchard Co. *v.* Hanley, 1897, 50 P. 611.

[69] (1880) 2 Fed. 877. On appeal, the Supreme Court concurred with the Circuit Court "that no such contract as this can be enforced in a court of equity when it is resisted and its immorality brought to light." But following its precedent it declared that "such contracts are not absolutely void, but are voidable at the election of the parties affected by the fraud." 109 U. S. 522, 524.

[70] (1903) 138 Calif. 308; and see Atala Iron Ore Co. *v.* Virginia Iron, Coal & Coke Co., Tenn. (1903), 77 S. W. 774, where it is said: "It is true the weight of the authorities is that such a contract is not void, but only voidable; and not withstanding the vice which tainted its origin, it may be subsequently validated. * * * * But we are dealing now with a case where an effort is made to enforce by recovery for its breach a contract so affected in its origin, and which has never been in any way validated, either expressly or

of the directors of a corporation became members of an association and as such interested in a contract with it adversely to the stockholders not members of the association, the contract was declared illegal. But here, as well, the sinister element was present. The contract was for the sole benefit of the association. In *Hutchinson* v. *Sutton M'f'g Co.*[71] the controlling directors of the two corporations were the same persons, and it was held that a preferential mortgage given by one to the other, as security for payments and liabilities resulting from an acceptance of drafts by the latter for the accommodation of the former, was invalid because it operated to protect the officers of the accepting company from personal liability for their maladministration, in accepting paper for accommodation. Here again it seems to have been rather the fact that the directors did what they had no authority to do—giving security for acceptance of accommodation paper—than the fact of common majority directorship that was determining. A case less affected by these extraneous considerations is *Lewis* v. *Petaluma Gaslight Co.*[72] However it is not entirely in point. It was held in this case that a contract made in behalf of a corporation, by a person who is its president and one of its directors, with a partnership composed of himself and another person, is void, since the director occupies a fiduciary relation to the corporation, such that he cannot take part in any transaction where he has an interest adverse to that of the corporation.[73] In *Greenwood Ice & Coal Co.* v. *Georgia Home Ins. Co.*[74] it was held that an insurance policy issued by an agent of the company to a corporation of which he is stockholder and officer is void. The court disposed of the matter thus summarily: "He thus occupied antagonistic positions, and, so situated as regarded the Greenwood Ice & Coal Co. and the appellee, it is not to be tolerated that the appellee [insurance company] shall be bound by the policy thus issued."

In *Pearson* v. *Concord Railroad Association*[75] it was said, "The

indirectly, by retention of its fruits, in whole or in part. We think to aid in the enforcement of such contract would be repugnant to the great rule of law which finds destructive voice in all contracts made by a trustee or fiduciary in which he is personally interested," etc.

[71](1893) 57 Fed. Rep. 998; Sutton M'f'g Co. *v.* Hutchinson (1894), 63 Fed. 496. And see the facts in Ward *v.* Davidson (1886), 89 Mo. 445, a very interesting case of common interest and bad faith. Drury *v.* Cross (1868), 7 Wall. 299.

[72](1901) 131 Calif. 656.

[73] And see numerous citations.

[74](1894) 72 Miss. 46, and citations. And see Trapp *v.* Fidelity Nat. Bank (Ky. 1897), 43 S. W. 470; Ernest *v.* Nichols, 6 H. L. Cas. 401; People *ex rel v.* Township Board (1863), 11 Mich. 222.

[75](1883) 62 N. H. 537.

relation of the upper companies to the Concord was that of buyer and seller. The upper companies desired to purchase of the Concord its transportation of their freight and passengers over the road of the latter. The Concord desired to sell the transportation over its own road of the traffic of the upper roads. It was for the interest of the upper companies to procure the lowest rates, and their directors were bound to use the knowledge they had derived from the confidence reposed in them as directors to attain that result; and the interest of the Concord was to procure the highest rates, and its directors were bound to use their special knowledge for the advantage of that company. Their interests being conflicting, it was impossible for common directors to procure the lowest rates for one party and the highest rates for the other." And it was decided that contracts could not be made nor claims settled under this arrangement.

IV.

THE NEW YORK DECISIONS.—This question has been under consideration more frequently in New York than elsewhere, and the decisions of the courts of that state are of peculiar importance, not only because of their influence, but because of the variation in doctrine which has marked their history. Such contracts meet with ready condemnation in the earlier cases; in 1896, and for some years thereafter the decisions maintain that there is something of a relaxation. This is followed soon, however, by resumption of approximately the original position.

The agreement between corporations having common directors receives definitive consideration in 1865. But several decisions of preceding years point the direction which the court would probably take. In 1842 a decision in chancery[76] declared it to be a settled principle of equity that a person who is placed in a situation of trust or confidence with respect to the subject of a sale cannot be a purchaser of the property on his own account—a principle not confined to a particular class of persons, such as guardians, trustees and solicitors. The rule of equity that no person can be permitted to purchase an interest in property where he has a duty to perform which is inconsistent therewith is declared to be of universal application. Likewise in 1856[77] the Court of Appeals declares "It has been settled by a long course of adjudication in the courts of equity,

[76] Torrey & Gilbert *v.* The Bank of Orleans, 9 Paige 648.

[77] N. Y. Cent. Ins. Co. *v.* Nat'l Protection Ins. Co., 14 N. Y. (4 Kern) 85; and see Cumberland Coal Co. *v.* Sherman et al. (1859), 3 Barb. 553.

that a trustee or agent of one person cannot make a valid contract respecting the subject matter to which the trust or agency relates, where he has a personal interest." And "It is not necessary for a party seeking to avoid a contract on this ground to show that an improper advantage has been gained over him," a principle applicable to executed or executory contracts. In this case the agent of one insurance company reinsured another company of which he was at the same time director and secretary. The contract was declared voidable in equity. The case is frequently cited in subsequent decisions involving contracts between corporations having common directors.

In 1865 the Supreme Court rendered a decision in the case of *St. James Church* v. *Church of the Redeemer*,[78] which is of initial interest. The churches were corporations. The Church of St. James had two wardens and seven vestrymen, the Church of the Redeemer two wardens and eight vestrymen. And one of the wardens and six of the vestrymen of St. James were also vestrymen of the Church of the Redeemer, and *vice versa*. Without any consideration paid to St. James, the majority of the common vestrymen conveyed certain real estate that belonged to it to the Church of the Redeemer. The court said, "The simple statement of these facts, so found by the court, without the support of other facts also found, establishes the fraudulent character of the conveyance." Perhaps some objection may be urged to this case on the ground that the agreement was one of gift rather than contract. The next case of importance on the specific point before us occurs in 1877. But in the interval there are one or two decisions emphasizing the trusteeship of the director. In 1867, in the case of *Butts* v. *Woods*,[79] it is decided that when an interested director must be included to constitute a quorum of the board which audits the bill rendered by him for services as secretary of the board, the board so constituted is not qualified to act upon such bill so as to bind the corporation.

The case of *Wallace* v. *Long Island R. Co.*,[80] decided in 1877, involved a lease between corporations having common directors. The court refused to permit disaffirmance at the suit of minority stockholders. It said, "The directors are no doubt, in one sense, trustees of the stockholders, but, primarily, they are trustees of the corporation * * * the mere fact that the same persons were

[78] 45 Barb. 356.

[79] 37 N. Y. 317. And it is said that any stockholder may sue for himself and any other stockholder who makes himself a party, to prevent the payment of such bill. This case is followed in Coleman *v.* Second Ave. Ry. Co. (1868), 38 N. Y. 201.

[80] 12 Hun 460.

directors of the corporation which made the lease and of that which took it, is not of itself sufficient to avoid the contract at the instance of one or more stockholders against the will of the corporation." But the court declared plainly "that fact alone might entitle either corporation to avoid the lease, but I apprehend it does not give that right to a stockholder."

The next case, that of *Marie* v. *Garrison*[81] decided in 1883, contains one of the most trenchant condemnations of these contracts to be found in the New York decisions, and, peculiarly enough, upholds the right of the stockholder to avoid the same. It is declared by the court that "this double action on their [the directors'] part was inconsistent with their legal duty to each company. In plain language it was a clear breach of trust, and their action was capable of being impeached in a court of equity, on the part of any stockholder who felt himself aggrieved." And further "The principle does not require that the power should be exercised corruptly. The power must not be allowed to exist at all. The court must hold with unflinching steadfastness that the dual directorship shall be disabled from representing the two corporations in any transaction requiring skill or judgment to be exercised for each."[82]

Yet *Metropolitan, etc., R. Co.* v. *Manhattan, etc., Co.*,[83] decided in 1884, pushes the doctrine a step farther[84] and in a decision which is one of the most important, as it is the longest decision written on this subject, puts such contracts on a par with contracts between the corporation and director. The court says "there is no difference in principle between the case of a director contracting with his corporation and that of directors of one corporation contracting with themselves as directors of another corporation. The evils to be avoided are the same, the temptations to a breach of trust are the same, the want of independent action exists, and the divided allegiance is just as apparent."

[81] 13 Abb., N. C. 214. Meanwhile it was decided in Van Cott *v.* Van Brunt (1880), 82 N. Y. 535, that a president and director of a railroad company might take the assignment of a construction contract, when done in good faith, with the knowledge and assent of all the stockholders and directors of the company, etc. The fiduciary character of the director is emphasized in Duncomb et al. *v.* N. Y., H. & N. R. R. Co. et al. (1881), 84 N. Y. 120. And the court says: "He falls therefore within the doctrine by which equity requires that confidence shall not be abused by the party in whom it is reposed, and which it enforces by imposing a disability, either partial or complete, upon the party entrusted to deal, on his own behalf, in respect to any matter involving such confidence."

[82] It is declared that "the principle governing the subject is nowhere more satisfactorily stated that in the case of New York Central Ins. Co. *v.* National Protection Ins. Co. (14 N. Y. 85)." See *supra.*

[83] 14 Abb. N. C. 103; 11 Daly 373.

[84] Such a position was announced, however, in Wallace *v.* Long Island R. R. Co., 12 Hun. 460-464, *supra,* to which this opinion makes reference, but it was without the force of the present decision.

In *Currier* v. *New York, etc., R. Co.*,[85] decided in 1885, the court took similar ground, declaring that where the same persons themselves, or through their associates[86] as directors controlled the two companies "they were simply contracting with themselves." The contract was declared presumptively fraudulent[87] and it was decided that the railroad company might at its election treat it as void and repudiate it. And, moreover, it was held that a stockholder or creditor might sue before making demand on the corporation, for it would be useless to make demand on the trustee as "the trustee is obviously unable to act by reason of being under control of the very persons who might be defendants in the proposed action."[88]

By 1888 the courts take a complacent view of the law, regarding the doctrine of avoidance as quite settled. Thus in *Stokes* v. *Phelps Mission*[89] it is said "the principle that corporations having common officers and trustees cannot enter into valid contracts with each other has become well established in the jurisprudence of this country and in England (*Metropolitan Elevated Railway Co.* v. *The Manhattan Railway Co.*, 11 Daly 373, and cases there cited) and needs no elaboration here." And "they must not contract, and if they do, such contract will be set aside at the instance of any party having the right to call the transaction in question." Indeed in cases decided in 1889 and 1891 such contracts are declared not merely voidable, but void. Thus in the case of *Barr* v. *N. Y., L. E. & W. R. Co.*,[90] decided in 1889, it was held that the law relating to the rescission of agreements fraudulently induced has no application in such a case, because the agreement itself creates no binding obligations.[91] But the case was reversed in 1891.[92] The court on reversal declared the contract to be voidable and not void, and subject to be validated by acquiescence and adoption. Because of failure to act diligently in asserting a right to rescind, the contract

[85] 35 Hun 355, and cases cited.

[86] There is an apparent, but seemingly not a very important, difference between this case and Marie *v.* Garrison, *supra*. The latter case declares that it makes no difference that the directors who were in both boards were not necessary to constitute a majority of each board.

[87] See the cases cited to this point, at p. 357 of the decision.

[88] See Leslie *v.* Lorillard et al (1888), 110 N. Y. 519, in which it is stated that "In actions by stockholders which assail the acts of their directors or trustees, courts will not interfere unless the powers have been illegally or unconscientiously executed, or unless it be made to appear that the acts were fraudulent or collusive and destructive of the rights of the stockholders."

[89] 57 Hun 570.

[90] 52 Hun 555, 5 N. Y. S. 623.

[91] And see Cole *v.* Millerton Iron Co. (1891), 59 Hun. 217, 13 N. Y. Supp. 851.

[92] Barr *v.* N. Y., L. E. & W. R. R. Co. (1891), 125 N. Y. 263.

having been executed, it was held to be ratified and equity would not intervene to set it aside.[93]

In a dictum by the City Court of Brooklyn[94] in 1892, the doctrine of close scrutiny and utmost good faith rather than that of general avoidance is espoused. In *Gildersleeve* v. *Lester,*[95] decided the following year, the application of the rule concerning avoidance to closely related conditions is declared to be "too clear for argument." In *Sage* v. *Culver*[96] decided in 1895, the court declared that a demurrer to a complaint was properly overruled, the complaint alleging, among other things, that the defendants, as officers and trustees of the defendant railroad, took from themselves as officers and trustees of another railroad, a lease of the latter, which they practically owned and managed, to the defendant railroad.

In *Hart* v. *Ogdensburg,*[97] 1895, the Supreme Court, recognizing that the corporation may disaffirm, declares that to justify interference of the court on application of a minority of the stockholders it must be shown that the action of the governing body must amount to a wanton and fraudulent destruction of the rights of such minority, and that such action is a clear, substantial and flagrant violation of rights. The "very able and exhaustive opinion" of VAN BRUNT, J., in *Metropolitan Electric R. R. Co.* v. *Manhattan Electric R. R. Co.*[98] is cited as authority with the comment that "the principle is here recognized that the majority of the stockholders may ratify a lease made by the directors, and that a minority cannot disaffirm. That, therefore, it must be the majority of the shareholders acting through the corporation who repudiate, and no shareholder has the power to exercise the right against the will of the majority."

Without preparation for any modification of principle we are informed by the Supreme Court in the case of *Genesee & W. V. Ry. Co.* v. *Retsof Min. Co.,*[99] that the rule permitting avoidance has been considerably relaxed. In criticism of the decision in *Wallace* v. *Long Island R. R. Co.*[100] declaring such contracts voidable, it is

[93] The case distinguishes Munson *v.* R. R. Co., 103 N. Y. 58, in that the contract involved therein was executory while this is an executed contract; and Wardell *v.* R. R. Co., 103 U. S. 61, in which the contract had been reasonably resisted, as "not parallel to this case, where concededly, no attempt has ever been made to annul the contract or lease and no offer made to return the property."

[94] Langan *v.* Francklyn, 29 Abb. N. C. 102.

[95] (1893) 68 Hun 532.

[96] 147 N. Y. 241.

[97] 89 Hun 316, 35 N. Y. S. 566.

[98] *Supra.*

[99] (1896) 36 N. Y. S. 896, 15 Misc. Rep. 187.

[100] 12 Hun 460.

said, "This, however, seems to be the mere expression of opinion, and does not harmonize with the language which preceded it, wherein it is stated that all the acts of the directors of a corporation, within their corporate powers, and done in *good faith,* are valid and binding not only upon the corporation but upon each stockholder thereof." The court declares that "the rule contended for by the learned counsel for the defendant has been considerably relaxed of late years. Indeed, it would be difficult to conduct the affairs of the multifarious corporations of this country * * * if the element of good faith, instead of individual interest, were not established as the basis of intercorporate action."[1] The opinion is in point, but the facts are such as to make it, perhaps, obiter. And the authorities in New York do not seem to sustain this claim of relaxation in any considerable degree.[2]

In 1899 in the case of *Burden* v. *Burden*[3] the old doctrines, at least so far as executory contracts are concerned, are reproduced in all their former vigor, the Court of Appeals declaring that "It is undoubtedly a well-settled rule of law that executory contracts entered into by corporations having common directors are voidable at the instance of either corporation, and the courts will not inquire into the question whether or not it is beneficial to the corporation seeking to avoid it." And "this right is vested in the corporation, and not in the individual stockholder."[4] A case decided in 1900, *Davis Provision Co.* v. *Fowler Bros. & Anglo-American Provision Co.*[5] presents a unique state of facts. A and B, as representatives of the defendant corporation, met with C, the manager of the plaintiff corporation, to adjust differences between plaintiff and defendant. It was held that a decision of A and B, without the consent of C, would not be binding upon the plaintiff, though plaintiff's board of directors consisted of A, B and C. The court said: "When two companies are acting at arm's length, each one acts only through its real champions, whatever the disparity between the number of persons on the respective sides."

In *Boaz* v. *Sterlingworth Ry. & Supply Co.*,[6] 1902, the agreement

[1] Citing Van Cott *v.* Van Brunt, 82 N. Y. 535; Gamble *v.* Queens Co. Water Co., 123 *id* 91; Twin Lick Oil Co. *v.* Marbury, 91 U. S. 587.

[2] Cf. Abbott's New York Digest, *sub verbo* Corporations, pp. 151, 152. But see 33 L. R. A. (1896) 790, where it is claimed that later New York cases had adopted a less stringent rule, citing Langan *v.* Francklyn, 29 Abb. N. C. 102; McComb *v.* Barcelona Apartment Assoc., 134 N. Y. 598.

[3] 159 N. Y. 287.

[4] The court makes but two citations as to these matters, one to Morawetz, § 243, and Leslie *v.* Lorillard, 110 N. Y. 532.

[5] 163 N. Y. 580.

[6] 73 N. Y. S. 1039, 68 App. Div. 1.

between corporations having officers and directors in common was condemned on the ground of breach of trust (so significant were the facts), little or no attention being given to the common directorship.

The cases of the years following up to the present are not fully in point, but indicate no derogation from what appears to be the established rule of avoidance by the corporation.[7]

It appears from the foregoing cases that the decisions of the New York courts both as to avoidance of the contract and the persons at whose instance it may be attacked have not always been harmonious. The rules with respect to both matters seem to be clear, but in the course of their development they have had to struggle with opposition.

That the contract is voidable on the sole ground of common directorship seems well established. This doctrine was approved in 1865 when the question was first clearly presented. The facts of the case, no doubt, were provocative of a stringent rule, but the rule continues unabated in 1883; it is made even more stringent in 1884; in 1888 it is considered as well settled by the decisions generally. Decisions in 1889 and 1891 pronounce such contracts void or invalid. But these cases hardly support the adoption of a new rule. The language is perhaps more vigorous, but the spirit of the opinions seems to be in keeping with that of preceding cases. In 1892 such contracts are declared to be subject to close scrutiny; the question of avoidance is not dwelt upon. In 1893 it is declared that the possibility of avoiding such contracts is too clear for argument. And while a relaxation is heralded in 1896 the cases do not appear to bear it out, and in 1899 the old doctrine of avoidance is embraced with renewed warmth.

The rule that the corporation alone can avoid the contract, that an individual stockholder cannot have it set aside, seems equally well established. And yet the rule is not without some deviation in the history of the New York decisions. Thus in 1883 it was held that such a contract might be impeached in equity on the part of any stockholder who felt himself aggrieved. But it was held that the contract concerned in this case was a clear breach of trust, which may place the decision on a somewhat different footing. In 1895 it was indicated that a court might interfere on the application of a minority in case of wanton and fraudulent destruction of the rights of the minority, the action being a clear, substantial and flagrant

[7] See Jacobus *v.* American Mineral Water Co. (1902), 77 N. Y. S. 898, modified in Jacobus *v.* Diamond Soda Water Mfg. Co., 88 N. Y. S. 302, 94 App. Div. 366; Polhemus *v.* Polhemus (1904), 88 N. Y. S. 273, 43 Misc. R. 141; United Gold & Platinum Mines Co. *v.* Smith, 90 N. Y. S. 199, 44 Misc. R. 567.

violation of rights. The prevailing rule of the state is well set forth in the last significant decision, that of 1899, in which it is declared that the right of avoidance is vested in the corporation, and not in the individual stockholder.

CONCLUSION.

A rule which exacts of the court anything less than rigid scrutiny of these contracts seems dangerous. Perhaps there are no circumstances which will justify immunity, the presumption that such contracts are *prima facie* fair and valid. If anywhere it would be where the boards of directors are identical and include all the stockholders,[8] or where the majority of the stockholders, both in number and in interest, ratify. Even then slight evidence of oppression of the minority should be sufficient fully to overcome such presumption.

On the other hand a rule that all such contracts are absolutely void would be unnecessarily rigorous. The decisions show that there is no danger of general adoption of such a doctrine, therefore slight consideration need be given to it. The acceptable rule would seem to be that which declares the contract voidable whether it be executed or executory.[9] The utmost good faith should be demanded on the part of those who make such contracts. And therefore to protect fully the interests of the minority, and of the individual, does it not seem necessary that the individual stockholder should be given power to institute proceedings which would lead to avoidance of the contract if any unfair advantage had been taken of him or other stockholders?[10] A mere showing that the two corporations between which the contract is made have common directors should be sufficient to constrain the court to take jurisdiction. Capable and

[8] See Reid, Corporate Finance I, pp. 262, 263, and cases cited.

[9] The decisions of the United States courts are among the best. SHIPMAN, C. J., in Robison *v.* McCracken (1892) 52 Fed. Rep. 726, said: "The decisions of the courts of the United States have been most strenuous in demanding that the directors of a corporation shall act disinterestedly in contracts which they make in behalf of the corporation for which they act, and in setting aside tainted contracts between a director or an agent and a third person for the sale of official influence."

[10] The proper relation of the majority to minority stockholders in the same and different corporations is well suggested in the following quotation: "When a majority of the stock of one corporation is owned by another, which thereby acquires the right to control its managament, the controlling corporation assumes a relation of trust towards the minority stockholders of the corporation controlled, and is under an obligation to manage its affairs for the benefit of *all* the stockholders, and not for its own aggrandizement. This is merely an application of the principle that, while a majority of the stockholders may legally control the corporation's business, they assume the correlative duty of good faith, and cannot manipulate such business in their own interest to the injury of the minority stockholders." Noyes on Intercorporate Relations, § 300.

adventurous officers and directors otherwise will not be sufficiently deterred from making such contracts in their own peculiar interest.

The mere fact that the contract has been executed should be of no force if the stockholders have not been duly apprised of the making and execution of the contract, and given a sufficient time in which to have it set aside. Ratification of a fair and reasonable contract by a majority of the stockholders should be conclusive, but they should have complete information and due notice when they act. Mere failure to act, their information being insufficient or misleading, should have no effect on their right of avoidance, no matter how long continued.

Rules such as these in this and legal relations of allied significance will do more than much legislation to establish a satisfactory basis for business negotiation and agreement, and do away with its besetting evils. For much of this disease is hidden. It lurks in the secret places of the law, places with which only the lawyer or astute financier can be familiar. It is all the more invidious in its secrecy. The cool precision of the judge can do more than is generally imagined to probe these dark places, and cut away this disease, and we should ask of him more than we have in the past.

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